



## Q&A: FSA USE-OR-LOSE RULE CHANGE

### BACKGROUND

A health flexible spending arrangement (FSA) is a benefit plan employers can sponsor that allows employees to cover medical expenses not covered by major medical insurance on a tax-advantaged basis. Generally, employees decide before the beginning of the plan year how much money they want to contribute to the FSA (an employer can make FSA contributions as well). The contributions are made through voluntary salary reductions, which means they are not included in the employee's income. Additionally, reimbursements used to pay qualified medical expenses, including copays, deductibles, vision and dental care, among others, are not taxed. For the past 30 years, health FSAs have been subject to a "use-or-lose" rule meaning funds left unused at the end of the year are forfeited to the employer. In 2005, the Internal Revenue Service authorized an optional grace period of up to 2½ months that employers can use in their plans, allowing use of the funds for up to 2½ months after the end of the plan year. And on October 31, 2013, the IRS issued new guidance allowing for a carryover of up to \$500 in unused funds. An employer must choose between the grace period and the carryover option; both cannot be offered simultaneously, though employers are not required to allow either.

### WHAT IS THE FSA USE-OR-LOSE \$500 CARRYOVER RULE CHANGE?

On October 31, 2013, the IRS issued new guidance allowing for a carryover of up to \$500 of unused funds in a health FSA into the next plan year. The carryover can only be offered for health FSA plans that do not offer a grace period of 2½ months into the next plan year to use any unused funds. The \$500 carryover does not affect the maximum \$2,500 annual contribution an individual can make to a FSA.

#### Notice 2013-71 Quick Facts:

- If the employer chooses to add the carryover provision, the employer must amend its cafeteria plan before the last day of the plan year, although plans making the change in can amend before the end of 2014.
- The employer cannot offer both the grace period and carryover. The grace period would need to be terminated in order for the carryover provision to be adopted.
- Any amendment would apply to all participants uniformly.
- Any amounts remaining after the claim run-out in excess of \$500 will be forfeited to the employer.
- Any carryover will not go against the \$2,500 salary reduction maximum; therefore, participants could have an account value in excess of \$2,500.
- Employees must be notified of the change.

### IS THE \$500 CARRYOVER MANDATORY?

No. The new carryover option is optional and is at the employer's discretion. However, employers would be wise to explore this option since experts forecast an increase in health FSA participation now that the #1 deterrent—the risk of losing funds at year's end – has been virtually eliminated.

### DOES AN EMPLOYER HAVE TO ALLOW THE MAXIMUM \$500 CARRYOVER AMOUNT?

No. An employer can determine a maximum carryover amount of less than the \$500 as long as the provision applies uniformly to all employees.

### WHAT IS THE DIFFERENCE BETWEEN THE IRS GRACE PERIOD AND THE NEW IRS CARRYOVER PROVISION?

The existing IRS Grace period allows an extension of time (up to 2½ months following the plan year) to incur expenses to use up funds (up to the \$2,500 cap) for the previous plan year. However, after the Grace period has expired, any unused funds are forfeited. In contrast, health FSA plans containing the new IRS carryover provision can allow up to \$500 of unused funds at the end of the plan year to be carried forward into the next plan year regardless of whether or not the employee continues to participate in the company's health FSA. It is important to note that funds carried forward do not reduce or affect the \$2,500 maximum cap on employee salary reductions to the health FSA.

### WHAT'S THE BETTER OPTION: A 2½ MONTH GRACE PERIOD OR THE \$500 CARRYOVER?

An employer really should review their demographics and consider what is typical for their employees. If year-end balances tend to be greater than \$500, they may benefit from a grace period feature so they have more time to incur and submit claims. If their year-end balances tend to be \$500 or less, they would certainly benefit from the carryover of funds to use the following

year. The grace period allows unlimited amounts to be used during a short window of time, while the carryover allows up to \$500 in unused funds to be used any time in future plan years.

An employer should also keep in mind that offering a \$500 carryover offers a no-risk proposition to employees who shy away from FSAs because of the use-or-lose forfeiture rule. The carryover could greatly expand employee participation.

#### **CAN A CARRYOVER BE OFFERED FOR UNUSED FSA FUNDS IN THE CURRENT 2014 PLAN YEAR?**

Yes. The new IRS guidance, which arrived just in time for open enrollment for the more than 170 million Americans covered by employer-sponsored plans, allows for employers to take immediate action. To do so, an employer must amend their plan document in writing on or before the last day of the 2014 plan year. In addition, if a health FSA plan currently offers a grace period the plan must be amended to remove that provision. Finally, all plan changes must be communicated to all employees.

#### **WHAT IS THE EMPLOYER PROCESS FOR ADDING THE NEW \$500 CARRYOVER PROVISION?**

1. The employer must amend their health FSA plan document to allow for the \$500 carryover provision, in writing, on or before the last day of the plan year.
2. The employer must announce the plan changes to employees before the end of the year.
3. If an employer offers an FSA grace period, which allows employees additional time following the end of the plan year, not exceeding 2½ months, to use up funds, the grace period must be eliminated before a carryover can be allowed. A plan cannot offer both options.

#### **DOES THE \$500 FSA CARRYOVER AFFECT THE \$2,500 INDIVIDUAL ANNUAL CONTRIBUTION LIMIT?**

No. Employees can still elect to contribute the maximum allowable annual \$2,500 contribution. For those who elect this maximum and carryover \$500 from the previous plan year, they can have a total of \$3,000 in tax-advantaged dollars to use to cover qualified medical expenses.

#### **DOES THE \$500 FSA CARRYOVER AFFECT EMPLOYER CONTRIBUTIONS?**

No. The \$500 carryover does not impact employer contributions.

#### **WHAT IF AN EMPLOYER OFFERS A 2½ MONTH GRACE PERIOD FOR FSAS—ALLOWING AN EMPLOYEE TO USE THE FUNDS UP TO 2½ MONTHS INTO THE NEXT YEAR; CAN THEY ALSO ADOPT THE CARRYOVER?**

No, in order to offer the \$500 carryover, an employer must first eliminate the grace period option from their plan documents. To make the \$500 available for 2014, the grace period must be eliminated—and health FSA plan amended—on or before the last day of the plan year.

#### **CAN AN EMPLOYER GIVE AN EMPLOYEE A CHOICE OF EITHER THE 2 ½ MONTH GRACE PERIOD OR CARRYOVER OPTION?**

An employer cannot offer employees a choice of a grace period or carryover. Only one option can be offered.

#### **WHAT IF THERE IS MORE THAN \$500 REMAINING IN THE FSA AT YEAR'S END?**

The carryover only allows for a maximum of \$500 at the end of each year. Any unused funds in excess of \$500 at the end of the plan year will be forfeited. Health FSA plan participants are encouraged to review their accounts now and employ smart strategies to use those funds for the end of the year.

#### **WILL THE PLAN PARTICIPANT BE ABLE TO CARRYOVER \$500 EACH YEAR AND GROW THEIR FSA ACCOUNT TO ACCUMULATE SAVINGS FOR FUTURE MEDICAL EXPENSES?**

No. The carryover is not cumulative. At the end of each plan year, up to \$500 of unused funds may be carried over for use in the next plan year. The carryover amount can never exceed \$500.

#### **WHAT IF SOMEONE DOESN'T ELECT AN FSA IN 2015, BUT HAS FUNDS REMAINING IN THEIR 2014 PLAN?**

If an employer elects to adopt the carryover provision for the 2014 plan year, any funds remaining in the an individual's 2014 health FSA will automatically be carried over in the 2015 plan year—even if the employee didn't elect to participate in a FSA in 2015. The employee will not forfeit any funds and can access the up to \$500 carried over to pay for qualified medical expenses incurred in 2015—and beyond—with tax-free dollars.

#### **WHAT IF AN EXISTING PLAN HAS A RUN-OUT PERIOD?**

The plan may specify a period of time after the end of the plan year during which employees can file claims for eligible expenses incurred during the plan year. However, the employer will have to make sure that any amounts used in that following plan year will first be applied against the carryover funds before being applied against current year contributions.

## **WHEN WILL THE FUNDS CARRIED OVER INTO THE NEW PLAN YEAR?**

The carryover funds will be available on the first day of the new plan year.

## **WHAT HAPPENS IF THE \$500 CARRIED OVER FROM ONE YEAR INTO THE NEXT PLAN YEAR ISN'T USED?**

A maximum of up to \$500 of unused funds will continue to carryover year to year and is available for use as long as the employee continues to remain employed at his/her current employer. If s/he leaves, the \$500 does not go with the employee but will be forfeited to the employer.

## **WHAT HAPPENS IF AN EMPLOYEE LEAVES THE COMPANY? CAN THEY TAKE THE \$500 CARRYOVER WITH THEM?**

No. FSA funds are not portable. If an employee leaves, the funds remaining in their FSA are forfeited to the employer.

## **ARE THERE EXCEPTIONS TO THE \$500 CARRYOVER RULE THAT COULD RESULT IN A "USE-OR-LOSE" SCENARIO?**

While the \$500 carryover will cut back on wasteful year-end FSA healthcare spending, there are instances where some health FSA policy holders will need to have a zero balance on or before the end of their plan year. The \$500 carryover provision is voluntary, so adoption is at an employer's discretion. In addition, if a plan currently allows for a 2½ month grace period, the carryover provision can't be offered unless the employer eliminates this provision. And if an employee currently has more than \$500 remaining in the health FSA, unused amounts in excess of the allowable carryover will be forfeited.

## **DOES THE PRESENCE OF HEALTH FSA ROLLOVER FUNDS AFFECT ONE'S HSA ELIGIBILITY?**

A health FSA is considered "impermissible coverage" when determining one's HSA eligibility unless it is designed to work with HSA rules. In other words, one cannot contribute to a HSA if benefits are available under a health FSA that pay before the minimum statutory deductible is satisfied. There are a few options to ensure that an employee can contribute to a HSA in 2015. They can spend down their FSA funds on or before the end of the plan year. There is also the option of electing a limited purpose FSA for the next plan year which will allow the \$500 rollover of unused funds without affecting their HSA participation eligibility.

## **DOES THE NEW ROLLOVER PROVISION APPLY TO DEPENDENT CARE FSAS?**

No, the new rollover provision only applies to health FSAs. On the other hand, the IRS 2½ month grace period can apply to either health and/or dependent care FSAs.

## **DOES THE NEW ROLLOVER PROVISION APPLY TO LIMITED PURPOSE FSAS – LIKE DENTAL AND VISION?**

Yes, up to \$500 in unused funds in limited purpose dental and vision FSAs (Limited Purpose FSAs are designed to be compatible with health savings accounts) may be rolled over as long as the rollover is offered to all employees.

## **WILL THE ROLLOVER IMPACT A PARTICIPANT WHO HAS MOVED FROM A FULL PURPOSE HEALTHCARE FSA TO A LIMITED PURPOSE FSA – AND VICE VERSA?**

If an employer elects to offer a rollover then the rollover will follow the participant's FSA plan design choice. If a participant elects a limited purpose FSA for the 2015 plan year, but had a full healthcare FSA in the 2014 plan year, any unused funds in the full healthcare FSA will roll over into the participant's newly chosen limited purpose FSA. This works the same if the participant moves from a limited purpose FSA to a full healthcare FSA.

However, if a FSA participant has elected a HSA for 2015, then s/he is advised to either spend down the FSA by year's end or elect a limited purpose FSA for 2015 to be sure s/he can contribute to a health savings account. If **any** funds remain in a full healthcare FSA and are rolled over into a full healthcare FSA in 2015, this precludes a participant from making any HSA contributions in 2015.

## **WILL THE ADOPTION OF A ROLLOVER IMPACT COBRA?**

No. COBRA will continue to operate as it does today.

## **WHAT ARE THE BENEFITS OF THE \$500 ROLLOVER FOR THE EMPLOYEE?**

- **Greatly Reduced Risk.** The 'use-or-lose' rule is the #1 deterrent for participation. In fact, 85 percent of large employers offer FSAs, but only 20-22 percent of employees take advantage of this tax-advantaged health benefit.<sup>1</sup> With the \$500 rollover of unused funds into the next plan year, the risk of forfeiture is greatly reduced. A study found the average amount left in FSA at the end of the year in 2012 was \$138.71.<sup>2</sup> And if someone elects a FSA with a maximum annual contribution of \$500, it's a no-risk proposition.

- **Greater Control.** The \$500 rollover means participants won't be pressured to spend down balances before a plan year ends—often times leading to wasteful spending. In addition, greater FSA participation equals greater consumer participation in their healthcare—connecting the patient with the real costs of services and products and empowering them to make smart decisions about how, when, and why their healthcare dollars will be spent.
- **Greater Savings.** Employee contributions are made through pretax salary reductions—which means they are not included in the employee's income. Reimbursements to pay qualified medical expenses are not taxed. Someone who elects to contribute \$500 to a FSA will save approximately \$150 in taxes; someone who elects \$2,500 will realize around \$750 in savings. Finally, the \$500 rollover will not have an impact on the \$2,500 FSA maximum contribution, which means an employee will have access to up to \$3,000 in a plan year to pay medical expenses.

#### WHAT ARE THE BENEFITS OF THE \$500 ROLLOVER FOR THE EMPLOYER?

- **Greater Flexibility.** The \$500 FSA rollover can be adopted immediately for the 2014 plan year. It's as simple as amending plan documents in writing before year's end, eliminating any grace period that allows use of FSA funds 2½ months into the new year, and communicating these plan changes to employees. The rollover can be adopted as part of the current open enrollment session. If open enrollment has already been closed, an employer can open a special session for employees to revisit their elections—and give employees who said no to FSAs (because they didn't want to risk losing funds) a chance to open a risk-free \$500 FSA for 2014.
- **Greater Participation.** Industry experts forecast an increase in employee participation among companies that enact the \$500 rollover rule. Forfeiture of funds has been the greatest barrier to employee participation. A study of consumer behavior<sup>2</sup> bears this out: Close to 70 percent said they don't like the rule that funds are lost if they aren't used by the end of the plan year. The \$500 rollover offers a safe and attractive option for those who have shied away from FSAs in the past.
- **Greater Savings.** Employers do not pay the 7.65 percent FICA taxes on employee voluntary salary reduction contributions. An employee election of \$500 would save an employer a little more than \$38 in tax savings; an election of the maximum allowable \$2,500 per individual will offer about \$190 in tax savings. These savings can be used to offset administrative expenses associated with offering this benefit; an anticipated increase in employee participation tied to the new \$500 rollover rule can help to completely offset this employer expense.